THE FRESH START

A Periodic Newsletter from the United States Trustee Offices for Region 11-Wisconsin and the Northern District of Illinois

SUMMER 2001

TABLE OF CONTENTS

From The Desk Of The U.S. Trustee. 1

News from Region 11. 2

Recent Region 11 Prosecutions. 4

Recent Court Decisions 7

Help Desk Opens at Bankruptcy Court 8

The ABC's of Adequate Protection Hearings. 9

From the Desk of the U.S. Trustee

Ever notice how new trends often start on the east or west coast and then gradually work their way into the midwest? Well, we're witnessing this occurrence right now in Chicago. What is this new trend? A new form of pre-pack chapter 11? No. A way to get around the new value exception to the absolute priority rule? No. An attempt by certain professionals to limit their potential future liability at the time of their retention in a case? ***Yes!!!*** *This new trend is called indemnification and it has begun to rear its ugly head in chapter 11 cases filed in Chicago.*

This is how it works. An investment banker, financial advisor, or accountant seeks to be retained to render services to a debtor in possession. Attached to the application is an engagement letter which contains a clause indemnifying the professional from a litany of possible future claims including ordinary negligence, breach of fiduciary duty and reckless or willful misconduct. The engagement letter may have been entered into pre or post petition. Why is this happening now, after these same professionals have been rendering services to bankruptcy estates for many years without seeking indemnification? Because in the past few years multi-million dollar judgments have been entered against certain professionals for mistakes made in the course of their engagement. How do the professionals *rationalize suddenly seeking indemnification in bankruptcy cases? In two ways, first that for years they've received indemnification in their non-bankruptcy engagements, and second, that the indemnification is part of their total compensation. In other words without the indemnification, they would have to charge more.*

In Region 11, and nationally, the U.S. Trustee Program takes the view that indemnification clauses should be stricken from all professional retention applications. There is no reason that a debtor-in-possession, on day one of a case, should give its professionals a free pass for their own negligence. It is hard to understand how a debtor-in-possession could ever justify such a provision as being in the best interests of the estate and its creditors. Whenever we see an indemnification clause as part of a professional retention application we will oppose it. This is one trend that is not going to work its way into chapter 11 cases filed in Region 11. Like pet rocks, chia pets and platform shoes, indemnification will soon be a thing of the past.

News from Region 11

On March 20, 2001, the United States Trustee Office (USTO) hosted *Fundamentals of Bankruptcy & Bankruptcy Related Crimes* training with 130 people attending, mostly from the federal law enforcement community.

Bankruptcy Analyst Thomas Thornton rejoined our Chicago office April 9, 2001. Tom left about two years ago. We are glad to have him back.

During April 11-13, 2001, Assistant United States Trustee (AUST) Sandra Taliani Rasnak attended a meeting of the National Bankruptcy Fraud Working Group in Albuquerque, New Mexico.

During the weekend of April 21 and 22, 2001, Sandra Taliani Rasnak addressed the American Bankruptcy Institute meeting in Washington, DC.

For the second year, a delegation comprised of judges and lawyers from the Peoples Republic of China visited the Chicago USTO on April 24, 2001, receiving a tour of the office, observing a chapter 11 creditors' committee meeting and discussing the roles of the office and of the private panel of trustees in the administration of bankruptcy cases with United States Trustee (UST) Ira Bodenstein.

On May 11, 2001, Tom Walz, Madison USTO trial attorney, gave a presentation about the pending bankruptcy legislation at the Northwestern Wisconsin Bankruptcy Institute held in Eau Claire, Wisconsin. The seminar focused on new technology and case law. Mr. Walz also answered questions about electronic case filing.

On May 21, 2001, the Chicago office welcomed student volunteers Anna Downs-Temple, an undergraduate at Franklin and Marshall College in Lancaster, Pennsylvania (our UST's alma mater), and

Adam Scott Fayne, a second year Kent Law School student. We hope their summer experiences provided a good overview of bankruptcy.

During May, three American Bankruptcy Institute sponsored seminars were attended by USTO staff. The 90 minute telephonic meetings covered consumer, tax, administrative and business issues involving the new bankruptcy legislation.

In May 2001, both AUST Sandra Rasnak and UST Ira Bodenstein spoke at the Annual Meeting of the Seventh Circuit Bar Association held in Indianapolis, Indiana. Ms. Rasnak spoke on fraud and abuse, and Mr. Bodenstein spoke on the new legislation.

On May 31, 2001, an open house was held at the United States Bankruptcy Court for the Northern District of Illinois, Eastern Division to celebrate the upcoming retirement of Wayne E. Nelson, Clerk of the Bankruptcy Court. Kenneth S. Gardner, named the new Clerk of the Court, will be sworn in August 30, 2001. Currently Chief Deputy Clerk for the U.S. Bankruptcy Court in San Diego, Mr. Gardner previously was Director of Criminal Operations for the Superior Court of California, San Diego County. Mr. Gardner earned a master's degree in judicial administration at the University of Denver College of Law, and has been instrumental in the implementation of imaging and electronic filing, both locally and nationally. Best wishes to Wayne Nelson on his well-earned retirement after 40 years of government service, and welcome to Kenneth Gardner.

Also on May 31, 2001, Region 11's UST, AUSTs and Trial Attorney Denise DeLaurent attended training in Dallas, Texas, provided by the Executive Office for U.S. Trustees (EOUST) regarding the new bankruptcy legislation. Milwaukee AUST John Byrnes was a featured speaker at that training on the topic of civil enforcement. Two additional training sessions were held in Columbia, South Carolina and Los Angeles.

On June 3, 2001, Christine Kriegl received a promotion from legal clerk to paralegal specialist, and is now responsible for supervision of Madison's panel trustees.

Brian Wright was recently appointed to the trustee panel in the Western District of Wisconsin, and will be administering chapter 7 cases in Superior, Wisconsin. Glenn Givens was recently appointed to the trustee panel in the Eastern District of Wisconsin, and will administer chapter 7 cases in Milwaukee, Green Bay and Oshkosh, Wisconsin.

On June 15, 2001, our office sponsored a debtor education demonstration program. The program was taught by an instructor provided by VISA using VISA-created financial management materials. The program was attended by 25 chapter 7 and 13 debtors, Judge Eugene Wedoff, UST Ira Bodenstein, other UST office personnel and both chapter 7 and 13 practitioners.

On June 25, 2001, a Japanese delegation met with Ira Bodenstein to discuss the role of the Office of the U.S. Trustee and the role of private trustees in the administration of chapter 7 cases. The delegation was comprised of members of the Japan Finance Association, an organization which oversees both credit counseling and financial education programs in Japan.

July 11, 2001 was Diversity Day for Region 11. Tour guides led our Madison, Milwaukee and Chicago staff through the *Wrapped in Pride: Ghanaian Kente and African American Identity* exhibit at the Field Museum. The exhibit focused on the cloth known as *kente* made by the Asante and Ewe peoples of Ghana. *Kente* is a hand-woven, narrow-strip cloth, often containing bright, primary colors with patterned motifs at regular intervals, long a part of the ritual culture of traditional Ghanaian society. Once known only to West Africans, today *kente* is worn all over the world. A pan-African symbol, it is produced in greater quantity, exported to more places and incorporated into a greater variety of forms than any other African fabric. Its bright, geometric designs can suggest royalty, sacredness or status. The exhibit included *kente* cloth, looms, documentary photographs and two simulated Ghanaian marketplaces.

Marilyn O. Marshall has been named Chicago's newest chapter 13 trustee. Ms. Marshall, a Louisiana native, is a Southern University School of Law graduate. She came to Chicago from Houston, where she was vice president and general counsel for Information Technology & Credit Corporation since 1994. We welcome our new trustee and it is good she arrived in August, in plenty of time to get used to Chicago winters.

Paralegal Benita Jones vacationed in Hawaii in July. This trip is about 4 years late - it turns out Benita won a contest sponsored by a local radio station, winning two airline tickets anywhere American Airlines flies. Benita was wise and chose Hawaii! Benita was unaware she had won until Jackie Walker, one of our trustees, heard Benita's name on the radio station, and told her to call the station to claim her prize. Some things are worth the wait!

AUST John Byrnes was a featured speaker at the EOUST Civil Enforcement Training held at the National Advocacy Center in Columbia, South Carolina during training held the week of July 30, 2001. Madison AUST Sheree Dandurand and Chicago trial attorney Richard Friedman attended this training. John Byrnes and Chicago AUST Sandra Rasnak were featured speakers at the same training held August 13-17, 2001. Trial Attorneys Steve Wolfe (Chicago) and Tom Walz (Madison) attended this session.

AUST Sandra Rasnak planned and participated in a meeting with Japanese Associate Professor Takeyoshi Imai, of Hosei University. Professor Imai has been asked by the Japanese Ministry of Justice to prepare a report comparing U.S. bankruptcy laws and Japanese bankruptcy laws. Professor Imai's inquiry focused on civil bankruptcy laws, civil remedies, contempt, and criminal law enforcement options. Many thanks to Chicago panel trustee Gus Paloian who served as a speaker and did an outstanding job describing the powers and duties of a chapter 7 trustee. The meeting was held from July 30 to August 1, 2001, in Washington, D.C.

We welcome the Honorable Bruce W. Black as a bankruptcy judge, sitting in Chicago.

We sadly report the passing away of the brother, father and mother of Pat Parker, Chicago legal clerk.

We also sadly report on the recent death of longtime chapter 7 panel trustee Tom Raleigh. Our condolences to the Parker and Raleigh families.

Recent Region 11 Prosecutions

On April 26, 2001, ten defendants were charged in 8 unrelated indictments and criminal informations with bankruptcy fraud and/or various related crimes in the Northern District of Illinois. Deputy U.S. Attorney Joan B. Safford, who supervises bankruptcy fraud prosecutions and heads the Chicago Bankruptcy Fraud Task Force, coordinated the cases. The task force, which was organized in 1987, brings together federal prosecutors, the USTO and agents of the FBI, Internal Revenue Service, Postal Inspection Service, HUD, Social Security Inspector General, and Department of Labor for a coordinated effort against bankruptcy fraud.

Deborah Holland, who owned and operated Harold's Chicken Shack #47, Calumet City, Illinois, was charged in a 19-count indictment with five counts of making false statements on loan or credit applications, four counts of bankruptcy fraud, four counts of bank fraud, three counts of mail fraud and three counts of concealing assets. According to the indictment, between June 1994 and September 1999, Holland schemed with her husband, mother, father and a mortgage broker - none of whom was charged - to defraud banks, various mortgage lenders, other creditors and bankruptcy trustees of more than $560,000. Holland allegedly fraudulently obtained mortgages to acquire and refinance her residence; fraudulently obtained credit from financial institutions, merchants and credit card companies by submitting false information, supplied counterfeit and false financial information to support her loan applications; and failed to make payments on loans, taxes and utilities. Between December 1996 and August 1998, Holland allegedly filed four fraudulent bankruptcy petitions and repayment plans to take advantage of the automatic stay of collection proceedings by her creditors, knowing that she would continue to conceal property from her creditors and would not complete the repayment requirements. In the bankruptcy proceedings, Holland allegedly concealed her ownership of Harold's Chicken, as well as her continuing income from the business and a 1995 Jeep Cherokee.

Ernesto G. Mutuc, a technical consultant for an international software design company, was indicted in a four-count indictment. The indictment charges Mutuc with one count of filing a bankruptcy petition in furtherance of a scheme to defraud and three counts of perjury in bankruptcy proceedings in connection with his filing of a petition on April 7, 1998. Mutuc allegedly concealed his interest in his Lake Shore Drive condominium, which he purchased outright for $146,784 after selling stock in the summer of 1997 for $158,725. According to the indictment he did not disclose the sale of stock and transfer of the funds and repeatedly lied about the condominium purchase, on the petition and in a deposition under oath, claiming that the stock proceeds had belonged to his sister and that the condominium was hers. He also allegedly concealed his claim against his ex-wife for $18,000, due on July 1, 1998, pursuant to their divorce decree. As a result of Mutuc's false representations, the appointed bankruptcy trustee made a finding that Mutuc had no assets and he was discharged from his debts to all creditors. The day after Mutuc's debts were extinguished, Mutuc allegedly went into Cook County Circuit Court to force his wife to pay the $18,000 claim.

Dale A. Bara, was indicted on three counts of concealing assets in connection with a voluntary joint bankruptcy petition that he and his wife filed on August 4, 1997. Bara allegedly concealed four bank accounts and ownership in restaurant equipment associated with Sharon's Gatehouse Restaurant in Streator, Illinois, including dishes, tables, chairs, refrigerators, stove, steam table and grill, and the fact that they had reached an agreement to sell the equipment for $20,000.

Gary L. Mingle, formerly of Chicago and now living in Dallas, was charged in a criminal information with one count of concealing assets. Mingle, who owned an industrial equipment leasing business called the Focus Group, Ltd., was forced into bankruptcy by creditors on September. 24, 1996. Between October 1996 and January 1997, Mingle allegedly concealed from his creditors Series EE U.S. Savings Bonds valued at approximately $50,000 and a 1992 Mercedes automobile valued at approximately $50,000. After the bankruptcy petition was filed, Mingle allegedly concealed the Mercedes by retitling it in the name of a fictitious company and parking it in a neighborhood garage, while using it as his personal vehicle.

Hasan Dervisevic, also known as "Hans Dervisevic," and his ex-wife, **Martha B. Dervisevic**, were indicted on four counts and three counts, respectively, of concealing assets. Both defendants filed separate voluntary bankruptcy petitions on April 1, 1997, about eight months after they were divorced. Both asserted that they owned no property, when, in fact, Hasan Dervisevic owned a one-quarter interest in a 23-unit apartment and commercial building in Chicago damaged by fire two months earlier in which Martha Dervisevic and another ex-wife each claimed an interest. About two weeks after filing for bankruptcy Hasan Dervisevic transferred his interest in the building to Martha and both defendants allegedly concealed their respective interests in the property.

Arleen Avery-Brown, also known as "Arleen Brown," "Arleen Fornis-Brown," and "Arleen Fornis," of Victorville, California and formerly of Woodridge, Illinois, was indicted on three counts of bankruptcy fraud and four counts of concealing assets. The bankruptcy fraud counts allege that in 1999 she defrauded two apartment landlords and a collection agency by sending letters with false notices of bankruptcy to get them to cease their collection efforts, when, in fact, she had not filed a bankruptcy petition. Later in 1999, and again in 2000, Avery-Brown filed two voluntary bankruptcy petitions and allegedly concealed assets, including three bank accounts, four investment accounts, her interest in her deceased father's life insurance and two automobiles.

Patricia A. Vlasek, also known as "Patricia Valo," was indicted on four counts of concealing assets and one count of social security fraud. The indictment alleges that in 1995 and 1996 Vlasek filed three voluntary bankruptcy petitions on behalf of her son and, in the third petition, failed to disclose the two previous filings. She also allegedly concealed her son's interest in four properties in Homewood and three trust accounts, along with the fact that the properties had been transferred between the trusts. Vlasek also filed her own voluntary bankruptcy petition in 1997, using a false social security number, and failed to disclose a previous bankruptcy filing in 1992, according to the indictment.

Thomas Lee Zemblidge, and **Mary Louise Zemblidge**, were indicted on three counts each of concealing assets in a bankruptcy case filed February 2, 1999. The couple allegedly concealed from creditors their stake in a 1997 personal injury lawsuit pending in Cook County Circuit Court, *Mary Zemblidge f/k/a Mary Devine v. Arlin Pitts and Crosstown Electric, Inc.*, 97 L 10996.

Chicago bankruptcy attorney **Erik A. Martin** and FM radio businessman and host **Christopher Claxton** were charged May 17, 2001, in a 15-count federal indictment with bankruptcy fraud and related offenses. The two allegedly concealed an arrangement in which Claxton solicited individual debtors through his radio broadcasts and referred them to Martin, who then filed personal bankruptcies on their behalf and shared substantial fees with Claxton or his businesses. Martin was charged with defrauding the bankruptcy court during 1995 and 1996 by failing to disclose in court filings that Claxton had referred more than 900 clients to him, and, in return, Martin had paid Claxton $200,000 from fees received from those clients. Martin and Claxton were charged with conspiring to defraud the U.S. Trustee's Office in 1997, when it began an inquiry into their financial relationship. From 1997 to 2000, Martin allegedly paid Claxton more than $1 million. In addition, Claxton alone was charged with bankruptcy fraud for failing to disclose all of his income from Martin, in his own personal chapter 7 case. Claxton allegedly failed to disclose all of his income, including payments from Martin in excess of $32,000 a month, between September 1999 and April 2000, among other false statements. Martin, who is one of Chicago's highest-volume personal bankruptcy petitioners, was charged with eight counts of bankruptcy fraud, two counts of making false statements and one count of conspiracy to defraud the U.S. Trustee's Office. Claxton was also charged with one count of conspiracy and four counts of bankruptcy fraud.

On May 25, 2001, the United States District Court for the Northern District of Illinois revoked the supervised release of **Frank Clay**. While on supervised release, Clay engaged in new fraudulent financial schemes. As a financial consulting service, Clay prepared bankruptcy petitions for hisclients, charging his clients/petitioners approximately $1,500 to file the bankruptcy petition. Because of his excessive fees, Clay was held in contempt by the Bankruptcy Court and ordered to refund all the fees, except for a reasonable charge of $100. In spite of being held in contempt, Clay continued to file bankruptcy petitions and to charge his clients $1,500 for his financial consulting services, and continued to state that he received $100 for filing the petition. Instead, Clay claimed he provided financial consulting services in connection with the bankruptcy filing. Clay also prepared bankruptcy petitions for clients who had quitclaimed their residential real estate to him. In the petitions, Clay failed to report that the client/petitioners had sold their residential real estate to him, instead falsely reporting that the client/petitioners owned the real estate. In preparing the asset portion of the petitions, Clay failed to report that he had given his client/petitioners a promissory note, valued between $2,000 and $4,000, to induce the client/petitioners to transfer the residential estate to him. In January 2001, Clay filed an amended chapter 7 petition and failed to claim as an asset the quitclaim deed that he received from his client, and also failed to list the $2,000 promissory note he gave his client in connection with the transfer of the quitclaim deed. Clay failed to update his petition to reflect two additional quitclaim deeds he received from clients approximately 30 days after converting to chapter 7. On his petition, Clay also failed to list restitution from Illinois and Wisconsin convictions. In the *Government's Rule to Show Cause*, it was noted that Clay had resumed the same conduct which resulted in his earlier convictions, which involved defrauding lending institutions, poor homeowners and the Department of Housing and

Urban Development and the Veterans Administration through the fraudulent purchase of eleven properties. Clay used newspaper ads to prey on unsophisticated and financially distressed members of the community. Clay was sentenced to 18 months in prison, followed by two years of supervised release.

A plea agreement was filed on July 25, 2001 in the Eastern District of Wisconsin in *U.S v. Jack U. Shlimovitz*. **Jack Shlimovitz**, a Milwaukee attorney, pleaded guilty to one count of criminal contempt, in violation of Title 18 U.S.C.§401(3). The government recommended probation. As part of the plea agreement, Shlimovitz will voluntarily surrender his law license, and not practice law for 5 years following sentencing. This investigation began when the Milwaukee USTO questioned Shlimovitz's handling of a bankruptcy case. The USTO believed Shlimovitz and his client, Terry Serwatt, intentionally misrepresented the value of a 10 acre property Serwatt owned. The property was valued at $70,000 in bankruptcy documents, and at the first meeting of creditors, although it eventually sold for $155,000. In a motion filed with the court, AUST John Byrnes wrote that "both the debtor and his attorney well knew that the value of the real property considerably exceeded the (listed) amount and that the property was not the homestead of the debtor...The above stated course of conduct constituted deliberate fraud upon the court and creditors and demonstrates bad faith."

Recent Court Decisions

The value of assets concealed by a defendant in a bankruptcy proceeding and income concealed from the Internal Revenue Service (IRS) should be considered in calculating a defendant's sentence under the U.S. Sentencing Guidelines, the U.S. District Court for the Northern District of Illinois held May 11, 2001 (*United States v. Chavin*, N.D. Ill., No. 99 CR 282-1, 5/11/01). Judge Rebecca R. Pallmeyer considered various challenges to the defendant's sentencing on bankruptcy fraud and tax evasion charges. Judge Pallmeyer addressed the objections and found nothing so prejudicial "that the verdict may fairly be questioned." Judge Pallmeyer sentenced Chavin to 37 months imprisonment, the top of the sentencing range. In addition to his prison term, Chavin was sentenced to two years supervised release, a fine of $10,000 and $16,526 in restitution.

A bankruptcy trustee can qualify as a "victim" of bankruptcy fraud for purposes of the Mandatory Victim's Restitution Act (MVRA), the U.S. Court of Appeals for the Seventh Circuit held June 20, 2001 (*United States v. Lowell*, 7th Cir., No. 00-4191, 6/20/01). The defendant, Scott Lowell, falsified his computer company's bankruptcy petition, got caught, pled guilty, and was sentenced to serve 18 months in jail and to pay a $2,500 fine, $90,000 in restitution to the bankruptcy estate and $40,000 in restitution to the bankruptcy trustee. Upon appeal, the case was remanded to the district court to "decide what, if any, restitution beyond $90,000 should be ordered." When the case returned to the district court, additional testimony from the trustee was offered and the court found the trustee to be one of Lowell's victims, and so Lowell was ordered to pay $25,906 in restitution to her. Lowell appealed again, arguing that bankruptcy trustees, like prosecutors or law enforcement officers, are otherwise compensated for their work and are thus not "victims" entitled to restitution. At 18 U.S.C. §3363(a)(2), the MVRA defines "victim" as a "person directly or proximately harmed as a result of the commission of an offense for which restitution may be ordered. . ." In an opinion by Judge Terence T. Evans, the Seventh Circuit emphasized that the trustee in this case was a "panel trustee" who retained a private law practice. "For this reason, a panel trustee is in a far different position than are direct, full-time, government employees, " Evans said, and pointed out that in bankruptcy proceedings, unlike criminal investigations, it is expected that the participants will conduct themselves in an honest manner. Moreover, a panel trustee is compensated on the basis of a percentage of the value of the assets liquidated and distributed; therefore, the defendant's interference with the trustee's ability to easily identify, liquidate, and disburse the assets the defendant attempted to conceal, reduced the trustee's compensation and increased her costs. Judge Evans' noted that in *United States v. Shadduck,* 112 F. 3d 523 (1997) the First Circuit relied on similar reasoning to enhance a sentence for bankruptcy fraud on the basis of the "multiple victims" enhancement provided by Section 2F1.1 of the U.S. Sentencing Guidelines.

Help Desk Opens at Court

In April 2001, a ribbon-cutting ceremony inaugurated the new Help Desk for the U.S. Bankruptcy Court for the Northern District of Illinois. The attorney-staffed service, sponsored by the Chicago Bar Association's Bankruptcy and Reorganization Committee is open each Thursday to give legal advice to *pro se* debtors. Debtors often fill out bankruptcy petitions and schedules incorrectly because they don't understand certain documents, and court officials are prohibited from answering questions that might be construed as giving legal advice. Sometimes lack of legal knowledge slows the filing process, causing people to miss work because they spend extra time in court. Within the first two weeks, the Help Desk was flooded with questions. The financial burden of attorney fees running from $500 to $1,500 for a chapter 7 case is one reason to file *pro se*, along with debtors being unemployed, elderly or facing large medical bills. About 750 people filed *pro se* in the first quarter of 2001, according to the Clerk of the Bankruptcy Court. As of April 2001, more than 12,600 people had filed for bankruptcy in the Northern District of Illinois. This 16% percent filing increase over last year may be due to anticipation over proposed legislation which would change current bankruptcy statutes.

The ABC's Of Adequate Protection Hearings by Richard Friedman [(1)]

Introduction Debtors in chapter 11 cases frequently seek to use property encumbered by the lien of a creditor. A lien is a "charge against or interest in property to secure payment of a debt or performance of an obligation." 11 U.S.C. § 101(37). Absent the consent of the lienholder, the debtor may not use such property without a finding by the bankruptcy court that the lienholder is "adequately protected." *See* 11 U.S.C. §§ 361 & 363. The purpose of this form is to assist parties at adequate protection hearings in determining whether a debtor's offer adequately protects the lienholder.

Key dollar amounts

A. The amount of the pre-petition debt: $

B. The value of the collateral securing the pre-petition debt: $

C. The value of the collateral securing the pre-petition debt on the end date of the cash collateral order: $

Key concepts

If B is greater than A, the lienholder is "oversecured." For example, suppose the debtor's house is the collateral for a $5,000 debt and is worth $100,000. If, however, B is less than A, the lienholder is "undersecured." Suppose the debtor's house is the collateral for a $100,000 debt, but is only worth $75,000.

If C equals or is greater than B, the lienholder is adequately protected. Even if C is less than B, the lienholder is still adequately protected provided C is greater than A. In that case, the lienholder is also oversecured and the "equity cushion" constitutes the lienholder's adequate protection.

If, however, C is less than B and also less than A, then the lienholder is not adequately protected. Where there is no equity cushion, that is, where the lienholderis undersecured, the lienholder has the right to not have the value of the lien eroded. Adequate protection, therefore, in such a case equals B minus C. The debtor must offer that amount to the lienholder either in cash or other property of an equivalent value. The debtor cannot offer to let that amount stand as an administrative claim. *See* 11 U.S.C. § 361(3).

Frequently Asked Questions **[2]**

1. If the debtor's cash position on the end date of the cash collateral order is worse than it was on the date of the initial hearing, isn't the lienholder entitled to an adequate protection payment to cover this loss of cash?

Answer: Even though cash on hand may have declined, the lienholder's position may not have deteriorated. The lodestar is not cash, but the value of all the lienholder's collateral, which may well include kinds of property other than cash.

2. How should an adequate protection payment in cash be applied ?

Answer: Arguably, the cash should not be applied, but held in escrow by the lienholder pending application pursuant to the terms of a confirmed plan. Where this is not done (and it seldom is), the payment should be applied to principal if the lienholder is undersecured. If the lienholder is oversecured, it is not entitled to adequate protection (because it has an equity cushion), but in the event a payment is authorized, it should be applied to interest and fees first, and, then, to principal. See 11 U.S.C. § 506(b) (oversecured creditor entitled to fees and interest).

3. Other than cash or a replacement lien, what else can serve as adequate protection?

Answer: Remembering that the debtor will only need to offer adequate protection where C is less than B, the debtor may not be able to operate and tender cash as adequate protection and a replacement lien is, ipso facto, insufficient. Under 11 U.S.C. § 361(3) other kinds of property, other than an administrative claim, may be offered, so long as they provide the lienholder with the "indubitable equivalent" of its interest in the property. In this circumstance the debtor may appropriately offer a lien on unencumbered assets such as bankruptcy causes of action or a junior lien on encumbered assets. Since such an offer may reduce the ultimate recovery for unsecured creditors, these creditors should be given an opportunity to exercise their business judgment in determining whether to support such an offer.

4. What happens if the approved adequate protection offer fails to adequately protect the lienholder?

Answer: In that event the lienholder receives an administrative claim that primes all other administrative claims. 11 U.S.C. § 507(b).

5. Under Fed.R.Bank.P. 4001(b)(2) "the court may authorize the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing." Doesn't this rule authorize the debtor's use of cash collateral on a preliminary basis without providing adequate protection to the lienholder?

Answer: Not quite. Under 11 U.S.C. § 363(c)(3) the court may preliminarily authorize the debtor to use such cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending the final hearing, provided the court finds there is a reasonable likelihood that the debtor will be authorized to use cash collateral at the final hearing. In making its assessment the court must find that the lienholder will be adequately protected during the interim period. See 11 U.S.C. § 363(e). In the event that the debtor is not allowed to use cash collateral at the final hearing because the interim adequate protection to the lienholder proved inadequate, see Question and Answer 4 above.

6. The debtor and lienholder have agreed that adequate protection will consist of the debtor's continuing to make its regular monthly payments to the lienholder on the secured obligation. Is there anything objectionable about such an agreement since it merely maintains the *status quo* existing before the bankruptcy case was filed?

Answer: The agreement is unobjectionable if the lienholder is in fact oversecured. Where, however, the lienholder is undersecured and the regular monthly payment includes interest, (as it likely does), the agreement is objectionable because only oversecured lienholders are entitled to interest. Instead of litigating the value of the lien, it may be more fruitful for the parties to agree that any application of the regular monthly payment to interest will be treated as "provisional," that is, alterable by the terms of any *confirmed plan or subject to the court's determination of any objection to the lienholder's claim.*

7. Question: Under certain conditions the lienholder not only will allow the debtor to use cash collateral, but also will extend credit to the estate. Is the lienholder in such a scenario entitled to adequate protection to cover its loan?

Answer: Adequate protection does not really apply to this scenario. Generally, a post-petition loan should be treated as if it were being made by a third party. The lender is entitled to the protections afforded by 11 U.S.C. § 364, none of which is properly characterized as adequate protection. (If the lender receives a priming lien to secure its loan, the party holding the primed lien is entitled to adequate protection). The post-petition loan is not an excuse to improve or enhance the lender's position with respect to pre-petition amounts owed to it. Thus, while it is proper for the lender to condition the making of the loan on the borrower's agreeing not to challenge the validity of any lien granted in consideration for the post-petition loan, it is not proper to demand that the borrower not challenge any infirmities in the lienholder's pre-petition documents. Similarly, payments to the lienholder should be applied to the post-petition loan, which quite often is on less generous terms than the pre-petition one. If the payments were applied to the pre-petition loan or attorney's fees and interest in connection therewith, not only would the lienholder's position be enhanced by receiving payment on its pre-petition debt, but the post-petition loan also might have to be greater than it would otherwise have to be, with additional higher interest paid by the estate to the detriment of other creditors.

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2. The views expressed herein are those of the author and do not necessarily represent the views of , and should not be attributed to, the United States Department of Justice or the United States Trustee Program. Readers of the Newsletter may e-mail additional questions to the author, who will do his best to reply. Such questions and answers may be included in a subsequent edition of this article.

For more information about this newsletter, or for additional copies, please contact: Alfreda Baran, Bankruptcy Analyst, USTO, 227 West Monroe, Suite 3350, Chicago, Illinois 60606, (312) 886-5785, or email Alfreda Baran at Alfreda.Baran@usdoj.gov

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